United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75-4227

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FOR THE SECOND CIRCUIT

EDWIN C. WHITEHEAD and
JOSEPHINE WHITEHEAD,

Appellants,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

ON APPEAL FROM THE UNITED STATES
TAX COURT

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P/S

REPLY BRIEF ON BEHALF OF APPELLANTS

ROBERTS & HOLLAND
Attorneys for Appellants
1301 Avenue of the Americas
New York, New York 10019

Of Counsel:

LAURENCE GOLDFEIN
MARK H. JOHNSON
RICHARD A. LEVINE
LARY S. WOLF

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APPELLANTS' REPLY BRIEF

INTRODUCTION

In his brief, Appellee[1/] has entirely failed to respond to several fundamental points raised by Appellants and has offered weak responses to Appellants' other contentions on the question of whether Ininco was a "controlled foreign corporation" within the meaning of section 957 of the Internal Revenue Code.[2/]

This brief will deal with Appellee's contentions and point out those issues raised in Appellants' brief which Appellee has overlooked.

1/ References in this Brief to Appellee refer to the Commissioner of Internal Revenue, the Appellee herein and the Respondent in the Court below.

2/ Hereinafter, section references in this brief, unless otherwise noted, are to the Internal Revenue Code of 1954, as amended (the "Code").

ARGUMENT

Ininco Was Not a Controlled Foreign Corporation Because Romney's 50 Percent Voting Power in Ininco Was Real and Meaningful, and, Accordingly, Cannot Be Disregarded.

(a) Romney's View of Its Voting Power

Appellee has failed to address himself to what Appellants believe is fundamental to the proper determination of this case; i.e., the preferred shareholder's intentions with respect to its voting power. The uncontested testimony of the preferred shareholder's Managing Director, Bernard Franklin, and the entire record of this case establish without doubt that: (1) Romney specifically bargained for, received, and intended to utilize, its voting rights to protect and retain its investment (App. 109A); (2) Romney was quite aware that it did not have to force a liquidation of Ininco or sell its shares, but could have chosen to do nothing and collected its dividends, which were secure, for many years (App. 127A-128A); and (3) Romney believed it had and, in fact, it did have real and meaningful voting power in Ininco.

The significance of these factors becomes all the more apparent in the discussion that follows.

(b) Economic Control

Appellants' position that the Tax Court improperly used a standard of economic control in determining whether Ininco was a controlled foreign corporation is set forth

in detail in Appellants' Main Brief at pages 39-47. As stated therein, concepts of economic control have no place in determining whether a corporation is a controlled foreign corporation either under the statute, the Treasury regulations, or this Court's opinions on the issue; rather, the test is one of voting control.

Two themes of economic control which appear to form the basis for the Tax Court's opinion are (1) Appellants' ownership of the company which controlled the supply of the product line on which Ininco's business was based and (2) the fact that Romney, as a preferred shareholder, had a limited economic interest in income of the corporation. Appellants have pointed out in response to these points that (a) by acquiring an interest in Ininco, Romney was not entitled to a voice in other companies owned by Appellants nor was it interested in the businesses of such other companies; rather, it was concerned about the assets and accumulated earnings only of Ininco, and (b) Romney had a substantial economic interest in Ininco and its voting power was designed to protect that interest.

Only in his discussion of the winding up of Ininco (Appellee Brief page 31) does Appellee refer at all to the economic control question, arguing that Ininco's existence was dependent upon the "cooperation of taxpayers". One can only wonder whether Appellee's short treatment of the economic control test applied by the Tax Court is an admission by

Appellee himself that he does not believe that economic control is the proper test. In any event, it is clear that Appellants' control over the supply of AutoAnalyzers would not jeopardize Ininco's existence as a viable entity in which Romney had a valuable stake. Ininco earned substantial profits and, at the time of the sale to Hong Kong Holdings, Ininco had more than $2,000,000 of accumulated earnings. As a result, Romney's investment and its 12-1/2 percent cumulative preferred dividend were secure for many years to come. Accordingly, control over the product line could not affect to any extent Romney's ability to exercise its voting rights to protect its investment and future dividend rights.

The record is clear and uncontested that Romney at all times could have forced a deadlock and continued collecting its dividend, and that Romney was aware of that fact. Appellee asserts (Appellee Brief page 31) that in a deadlock situation Intapco could have forced dissolution by offering its shares for sale, thereby forcing a liquidation. However, such a liquidation would have resulted in the imposition of a 40 percent United Kingdom tax, and further, Whitehead testified as to his fear that a falling out with Romney might have been disruptive to Technicon's business. (App. 56A-57A.) Appellee does not directly deal with these crucial facts; rather, he merely notes in passing (Appellee Brief page 32, footnote 10) that a "liquidation" of Ininco was managed without the resulting

40 percent tax. It must also be noted, however, that the winding up of Ininco was by a sale which was accomplished only with the cooperation of Romney. Romney's right to oppose such a sale was a powerful economic weapon, the exercise of which would have forced a liquidation and made it impossible to save the 40 percent United Kingdom levy.

Appellee says that Romney had a "limited economic stake in Ininco." That statement must be scrutinized in the context of all the circumstances of this case. Upon the incorporation of Ininco, Intapco, the United States common shareholder, and Romney, the non-United States preferred shareholder, made approximately equal cash investments in Ininco. The preferred shareholder was entitled to a cumulative 12-1/2 percent return on its investment and a preference over the common shareholder for return of its investment and unpaid dividends. While Romney's relative share of total accumulated earnings of Ininco was lower than Intapco's, its interest in protecting its economic investment was no less strong than Intapco's. In view of the fact that the sine qua non of the capitalization structure of Ininco was equal voting power between Romney and Intapco, the size at any one point in time of Romney's investment in relation to Appellants' original investment plus accumulated profits is not important in determining whether Romney had real and meaningful voting power. What is important is that Romney insisted on and received equality of voting power as a means to protect its investment and would not have made the investment

in Ininco without such voting power.

(c) Kraus and Garlock

Appellants' Main Brief quite clearly shows that the facts in Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973), cert. denied 417 U.S. 911 (1974), and Kraus v. Commissioner, 490 F.2d 898 (2d Cir. 1974), are entirely different from the facts of the instant case. Yet, Appellee, like the Tax Court, tries to borrow phrases from those decisions and make them fit this case. For example, Appellee, on page 24 of his Brief, cites the "defied credulity" phrase used by this Court in Kraus. As pointed out in Appellants' Main Brief at page 41, it does not "defy credulity" that Romney, the preferred shareholder, had 50 percent of the voting rights in Ininco because, as established in the record in this case, the substantial business purpose of gaining Overseas Trade Corporation status under United Kingdom law was thereby achieved. It was for this reason, wholly unrelated to United States tax consequences, that Appellants agreed to take only 50% control of Ininco.

The statement on page 24 of Appellee's Brief that "Like here, there was no arrangement for the breaking of a deadlock..." is another example of an erroneous attempt to bring this case within the rationale of Kraus and Garlock. As pointed out in Appellants' Main Brief (page

35), the deadlock feature in this case shows the exact equality of voting power which existed between Romney and Intapco at the shareholder level and on the Board of Directors.

On page 25 of his Brief, Appellee's attempt to equate Romney's sale of its shares in Ininco to the sale by the preferred shareholders in Kraus is also without merit. Whereas the preferred shareholders in Kraus simply went along with the sale, in this case it was necessary to request and obtain Romney's consent. Romney's first reaction to Appellants' request for a sale was negative. It later agreed to sell its shares because it understood that the reason for a sale (i.e., repeal of the Overseas Trade Corporation legislation) was beyond the control of Appellants. (See also the discussion at pages 11-13, below.)

In sum, while the Tax Court and Appellee have tried to fit this case within the mold of Kraus and Garlock, such casting is simply not possible.

(d) Tests of the Treasury Regulations

Appellee on pages 20 and 21 of his brief, discusses the tests set forth in Treasury Reg. Section 1.957-1(b) to be applied in determining controlled foreign corporation status. It appears that Appellee is trying to fit this case within one or more of the tests of the regulations, although the Tax

Court below did not do so. It must again be pointed out that the first test of the regulations is not met since there was no evidence, and indeed, the Tax Court did not find, that there was any agreement or arrangement between Romney, on the one hand, and Weiskopf and Whitehead, on the other hand, with regard to how Romney would exercise its voting rights or as to Romney not voting its shares. Moreover, there is no evidence, or finding by the Tax Court, to indicate that the stock owned by Romney was voted on behalf of Appellants.

In his brief, Appellee paraphrases the three-pronged test set forth in Treasury Reg. Section 1.957-1 (b)(2), and attempts to show how all three elements of that test have been met in this case. This test provides that voting power of a second class of stock will be disregarded if (1) its percentage of voting power is substantially greater than the stock's proportionate share of corporate earnings, (2) the shareholders do not exercise their voting rights independently, and (3) a principal purpose of the arrangement is to avoid having the corporation classified as a controlled foreign corporation.

Appellee's reference to Romney's return being limited to a 12-1/2 percent yearly dividend must be put in proper perspective. Romney had a preferred stock inter-

est in Ininco which gave it a greater rate of return that it received on its other investments, and a greater rate of return than bank lending rates for good risks. (App. 138A-139A.) In this connection, Appellee should be taken to task for the innuendo that Ramney considered its investment in Ininco to be a debt instrument. (Appellee Brief page 27.) This is picking on what is clearly the slightly different syntax of words used by Franklin, a United Kingdom citizen. Obviously Franklin understood the difference between preferred stock and loans and knew that his interest was a stock interest with a fixed dividend rate. It should also be pointed out that in the Tax Court Appellee argued that the interest of Romney was debt, but no mention was made of this by the Tax Court, nor, understandably, is it here seriously asserted by Appellee.

The statement on page 28 of Appellee's Brief that "taxpayers are hard pressed to assert that Romney's nominal voting rights and its stake in Ininco were in some sort of equilibrium" not only distorts the facts, it misses the point entirely. The statutory test is not one of equilibrium; the test is voting power. Not only were the voting rights owned by Romney equal to the voting rights owned by Intapco, Romney's view of its stock interest in Ininco gave it the economic incentive to exercise its voting power, and the economic impact

of Romney's voting power on Appellants ensured that Appellants could not disregard its voting power. Appellants could not and did not exercise their voting power in disregard of Romney's voting rights.

Appellee asserts that Appellants retained dominion and control over Ininco and that Romney did not exercise its voting rights independently. In support, Appellee avers that Romney gave up its voice in Ininco to Evans. (Appellee Brief pages 14 and 28). Such a statement, however, is not supported by the evidence. Evans, the secretary of Ininco, performed the function of Managing Director (President) of Ininco, although he did not hold that office. (App. 66A-67A.) While Franklin did not become involved in the day-to-day operations of Ininco, he attended informal meetings from time to time with Evans to review financial matters relating to Ininco. (App. 133A.) Evans did not have the power to act on behalf of Romney or to exercise Romney's voting power. Romney did not cede its voting rights in Ininco, rather, by conferring periodically with the person who conducted the day-to-day operations of Ininco, Franklin took steps to assure that Romney's voting rights and its investment were protected.

Appellee attempts to infer that Romney was not truly interested in the affairs of Ininco by pointing to Mr. Goldwater's representation on the Board of Directors as an

appointee of Romney. (Appellee Brief page 29.) In response, it must be noted that although Franklin only recalled Mr. Goldwater's attendance at one Board of Director's meeting, he in fact attended three meetings held during the period Ininco was an active corporation. (Exhibit 23-W, App. 219A; Exhibit 24-X, App. 220A; Exhibit 25-Y, App. 221A.) Appellee's attempt to draw a negative inference from the statement that Franklin did not confer with Mr. Goldwater as to how he should vote on any particular matter before a meeting was held is improper. There is nothing to indicate that Goldwater did not vote exactly as Franklin and Romney wanted him to vote. Moreover, Franklin testified that no agenda were provided for Board meetings and that in a private company such as Ininco it would have been most unusual for an agenda to be provided. (App. 132A.) Furthermore, pursuant to the Articles of Association (Exhibit 10J, paragraph 84(1)), Romney had the right by simple letter to Ininco to remove a director and appoint a new director. Thus, if Mr. Goldwater had not voted in a manner which Franklin desired, Romney could have simply removed Mr. Goldwater and appointed a new director.

Appellee contends that the events leading up to the sale of Ininco reveal that Romney failed to exercise its voting power. Appellants' solicitor, Carr, worked out an arrangement for the sale of Ininco to Hong Kong

Holdings. As Appellants pointed out in their Main Brief at pages 43-45, it is natural that Carr, having advised Appellants that the Overseas Trade Corporation law had been repealed and that it was advisable to try to wind up Ininco, would first work out an arrangement with a prospective purchaser before making overtures to the preferred shareholder. That is the way any businessman would have conducted his affairs. After Carr worked out the general terms of an agreement with Hong Kong Holdings, he approached Franklin to ask for Romney's approval, rather than try to deal with Franklin in hypotheticals. It should be noted that it was not until approximately two months after Romney was contacted, that the terms of the agreement with Hong Kong Holdings were finalized, and the agreements executed. (Romney was contacted on December 21, 1965 (see Exhibit 38, App. 231A) and the agreement with Hong Kong Holdings was executed on February 21, 1966 (see Exhibit 20-T).)

Appellee infers (Appellee Brief page 30) that since Romney accepted a premium of only 900 pounds, it did not exercise its voting rights independently. On the contrary, the fact that a premium payment was demanded and paid shows Romney believed that it did have real and meaningful voting power and that it did exercise its voting power independently. The facts show that Franklin was indignant when first told

of the planned sale. He realized, however, that the reason for the sale, i.e., termination of special treatment of Overseas Trade Corporations, was beyond the control of Whitehead and Weiskopf. Merely because Romney acted honorably and did not exact a severe "penalty" from Appellants, does not justify an inference either that Romney did not have real and meaningful voting rights or that it did not exercise its voting rights independently.

Appellee avers on page 32 of his Brief, that "[c]learly a principal purpose for giving Romney a nominal 50 percent voting right in Ininco was to avoid having Ininco classified as a controlled foreign corporation." Appellee ignores the Tax Court's failure to find a United States income tax avoidance motive and supports his assertion by resorting to speculation and improper inferences rather than to facts. Appellee argues, in essence, that since Ininco was formed to qualify as an Overseas Trade Corporation in order to benefit from United Kingdom tax deferral, it should be inferred that a principal purpose must also have been to avoid United States income taxes. Such an inference is completely unjustified and not supported by the record. The British solicitor who advised Appellants testified that the idea for the creation of Ininco and for the capital structure it took was based solely on his advice concerning United Kingdom law and that there were no

discussions whatsoever concerning United States income tax consequences. His testimony was corroborated by Appellant Whitehead and by Franklin, the person who represented the preferred shareholder. Further, since Ininco did not earn Subpart F income, its current earnings would not have been subject to United States income tax under sections 951 through 959 of the Code, even if Appellants had owned 100 percent of the voting stock. The only possible United States tax benefit to Appellants would have arisen on the future sale or liquidation of Ininco. However, as the record establishes, at the time of its creation Ininco was intended by all concerned to be a permanent fixture, with no such disposition contemplated. (App. 110A, 113A, 116A.)

Appellee also argues that a United States avoidance motive may be inferred because Ininco enabled Appellants to shift potential income away from Technicon, a domestic corporation, and United States taxes were thereby reduced. However, this course of conduct is permitted under the Internal Revenue Code. That reducing United States taxes by means of establishing viable foreign corporations is perfectly proper cannot be seriously disputed. Moreover, while it is true that a complex procedure for terminating Ininco's existence was effected in order to avoid United Kingdom tax, it must be noted that the procedure was reviewed and accepted by

United Kingdom tax authorities. It is also true that an Irish corporation was granted an exemption from Irish tax; but this exemption came directly from the Irish government. To argue from the foregoing that Sections 957 and 1248 of the Code were a "primary consideration in structuring Ininco" is totally unwarranted.

Appellee points to the fact that Appellants discussed the formation of Ininco with attorneys Mark Johnson and Alvin Lurie who represented them during that period. (Appellee Brief page 5, footnote 3; page 33.) Morely because the formation of Ininco may have been discussed with counsel does not permit an inference that a primary consideration for the capital structure of Ininco was the avoidance of classification as a controlled foreign corporation. Such an inference is in direct conflict with the testimony which was given at the trial to the effect that United States tax considerations did not play a part in the capital structure of Ininco. (App. 57A, 83A, 84A, 120A, 162A.)

It is thus apparent that under the tests set forth in Treasury Reg. Section 1.957-1(b), Ininco cannot be classified as a controlled foreign corporation.

(e) CCA, Inc.

The Tax Court has held that a corporation can issue

a common and a preferred class of stock, each class having equal voting rights, and yet not be classified as a controlled foreign corporation. CCA, Inc., 64 T.C. 137 (1975). As a final point in his argument relating to the controlled foreign corporation issue, Appellee (Appellee Brief page 33) attempts to distinguish the Tax Court's decision in CCA, Inc. from the decision on the case at bar. Appellee incorrectly states that in CCA, Inc. the non-United States shareholder held more than 50 percent of the voting rights. In CCA, Inc., as in the case herein, there was exact equality of voting power between the non-United States preferred shareholders and the United States common shareholder. Appellee is not alone in his difficulty in trying to distinguish the two cases. For example, in Bailey, Using Voting Preferred Stock to Avoid CFC Status, 2 International Tax Journal 101 (1976), the author notes at page 112 that:

> "It is difficult to reconcile the different holdings of Weiskopf and CCA, Inc. Seemingly, the difficulty stems from the fact that the Tax Court made too short shrift of Weiskopf."

Respectfully submitted,

ROBERTS & HOLLAND
Attorneys for Appellants

Of Counsel:

Laurence Goldfein
Mark H. Johnson
Richard A. Levine
Lary S. Wolf

AFFIDAVIT OF SERVICE BY MAIL

STATE OF NEW YORK,
CITY OF NEW YORK,
COUNTY OF New York, ss.:

Julius Talmer, being duly sworn, deposes and says that he is over 18 years of age. That on the 22nd day of March, 1976, he served 2 copies of the within Brief upon Scott P. Crampton, Esq., the attorney for the the above-named Appellee, by depositing 2 copies of the same securely enclosed in a post-paid wrapper in a branch depository maintained and exclusively controlled by the United States Post Office at Hemmerich & Costey Streets, addressed to said attorney for the Appellee at No. Tax Div. U.S. Dept. of Justice Washington, D.C. 20530 that being the address within the State designated by him for that purpose upon the preceding papers as the place where he regularly kept an office, and at which place ~~they~~ he regularly received mail.

Sworn to before me this
22nd day of March, 1976.

Sylvia Morris

SYLVIA MORRIS
Notary Public for the State of New York
No. 31-4523651
Qualified in New York County
Commission Expires March 30, 1976

Julius Talmer